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In the

Supreme Court of the United States

OCTOBER TERM, 1976

No. 75-1771

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

STANDARD LIFE & ACCIDENT INSURANCE COMPANY,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR THE RESPONDENT

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ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR THE RESPONDENT

QUESTIONS PRESENTED

Deferred and uncollected premiums are premiums that have not been paid to a life insurance company by the end of a tax year but that would have been received if all premiums were paid annually on the anniversary date of each policy. This case presents two questions as to the application of particular provisions of the Internal Revenue Code of 1954, as amended in 1959, to such deferred and uncollected premiums: (1) Is any part of deferred and uncollected premiums to be included in a life insurance company's taxable income? (2) In the computation of taxable investment

income, is any part of deferred and uncollected premiums to be included in a life insurance company's assets? An additional question presented by Petitioner is whether not including deferred and uncollected premiums in taxable income and assets requires any adjustment in a life insurance company's life insurance reserves.

STATEMENT

Respondent is a life insurance company organized under the laws of the State of Oklahoma. In computing its liabilities for federal income taxes for the tax years here at issue, Respondent was subject to the provisions of Sections 801 through 820 of the Internal Revenue Code of 1954, as amended in 1959.[1] These provisions basically provide for the taxation of life insurance companies on their gain from operations or on their taxable investment income or in part on gain from operations and in part on taxable investment income.[2]

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[1]Life Insurance Company Income Tax Act of 1959, Pub. L. No. 86-69, 73 Stat. 112 (1959). Unless otherwise specifically indicated, all section references in this Brief shall be to the Internal Revenue Code of 1954, as amended in 1959 and applicable to Respondent's 1958, 1959 and 1961 tax years.

[2]Under Section 802(b)(1), a life insurance company is taxed at regular rates on the lesser of taxable investment income or gain from operations. This element of taxation is normally referred to as "Phase I." In addition, under Section 802(b)(2), if gain from operations exceeds taxable investment income, 50% of the excess is taxed at regular rates in "Phase II." An additional "Phase III" tax on amounts deemed to be distributed out of previously untaxed income is authorized under Sections 802(b)(3) and 815; Phase III is not involved in this case.

"Deferred and uncollected premiums" on insurance policies in force at the end of a life insurance company's tax year arise when insurance premiums are paid in installments rather than fully by the end of the tax year and also when, at the end of the tax year, policies are outstanding that have been extended under "grace period" provisions even though the premium for such period has not been paid (Stip. pars. 7-8, A. 16-17). With respect to both categories of deferred and uncollected premiums, the premium has not been paid by year-end and there is no legal requirement that the policyholder or any person pay such premium. If the premium is not paid, the only consequence is that the life insurance policy will lapse after a specified period (Pet. App. B 11a).

The amount of deferred and uncollected premiums at the end of a particular year may normally be divided into two basic parts: the net valuation portion and the "loading" portion. The net valuation portion of deferred and uncollected premiums is the amount that is assumed to have been paid in the computation of life insurance reserves as required by state law. "Loading" is the difference between the total premium and the net valuation premium and may generally be viewed as an amount set by each particular life insurance company to be added to the net valuation premium for estimated acquisition, administration, management, and operating expenses, for contingencies, for profits in the case of capital stock companies, and for dividends in the case of mutual companies (Stip. par. 6, A. 16).

Respondent computed its life insurance reserves as required under Oklahoma law on the assumption that all premiums including deferred and uncollected premiums had been paid in advance at the anniversary date of each policy (Stip. par. 11, A. 17). The reserves as so computed were required to be maintained by Oklahoma and other state authorities regulating the operations of Respondent, and such reserves were shown by Respondent for each year at issue on the annual statement form approved by the National Association of Insurance Commissioners (Stip. pars. 3, 11, A. 15, 17; Exs. E, F, H, A. 61, 76, 91).[3]

In reporting its income on the NAIC annual statement form, Respondent showed deferred and uncollected premiums as a part of premium income and, as required by the form, showed a deduction for the loading portion of deferred and uncollected premiums (Exs. E, F, H, A. 62, 65, 77, 80, 92, 95). Similarly, the net valuation portion of deferred and uncollected premiums was shown as an asset on the annual statement forms. (Exs. E, F, H, A. 60, 72, 75, 87, 90, 102). This treatment of deferred and uncollected premiums is required by the NAIC to balance the net valuation portion of deferred and uncollected premiums that is

[3]Under Treasury Regulation §1.6012-2(c) a life insurance company's annual statement on the NAIC form "which shows the reserves used by the company in computing the taxable income reported on its return" must be filed with the company's tax return.

assumed to have been received in the computation of life insurance reserves.[4]

In the computation of a life insurance company's gain from operations, premium income is treated as one item of gross income.[5] A deduction is allowed for the increase (if any) in certain reserves including life insurance reserves.[6]

The computation of a life insurance company's taxable investment income is more complicated. Such computation involves determining an "earnings rate" for each year calculated by dividing "investment yield" (essentially investment income less expenses) by the total of certain assets of the company.[7] The average of the current and the preceding four years' earnings rates (or only the current earnings rate if it is lower than the average)[8] is then multiplied by the "adjusted" current year's life insurance reserves[9] (which are adjusted to

[4]*See* Official Report of the Proceedings of the National Insurance Convention of the United States 68-70 (1871).

[5]Section 809(c)(1).

[6]Section 809(d)(2). A net decrease in reserves is treated as an item of income under Section 809(c)(2).

[7]Section 805(b)(2). The term "investment yield" is defined in Section 804(c) and the term "assets" is defined in Section 805(b)(4). The amount of assets for a particular year is the mean of a life insurance company's assets at the beginning and end of such year (Section 805(b)(2)(B)).

[8]Section 805(b)(1), (2) and (3).

[9]Section 805(a)(1). For purposes of these computations, the amount of life insurance reserves for a given year, before adjustment, is the mean of such reserves (other than pension plan reserves) at the beginning and end of the year (Section 805(c)(1)(A)).

take into account differences between the company's earnings experience and the earnings rates assumed in the computation of reserves)[10] to determine a part of the investment income that is to be allocated to the holders of life insurance policies and hence is not to be subject to tax.[11] A review of this description will reveal that the amount of investment income excluded from tax will vary directly with the amount of life insurance reserves; because of the adjustment of life insurance reserves to take into account earnings experience, there is no simple invariant relationship between the amount of assets included in the computation and the amount of investment income excluded from tax.[12] No proportional relationship between reserves for a particular year and assets for a particular year is required to be maintained in the computation of taxable investment income. To the contrary, the statutory provisions contemplate a number of adjustments in reserves that do not involve the maintenance of any particular proportional relationship or consistency of treatment as between reserves and assets for a particular year.[13]

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[10]Section 805(c)(1). This adjustment is discussed at pages 31-34 *infra*.

[11]To the amount determined as described above, there are added earnings attributed to pension plan reserves (Section 805 (a)(2)) and interest paid by the life insurance company (Section 805(a)(3)). The sum of these items is then divided by the "investment yield" and the resulting percentage (not in excess of 100%) is then multiplied by each item of income to determine the amount of such item allocated to policyholders and therefore not subject to tax. *See* Section 804(a)(1).

[12]*See* pages 30-35 *infra*.

[13]*See* pages 33-35 *infra*.

This case specifically involves the tax treatment of Respondent's deferred and uncollected premiums for the years 1958, 1959 and 1961. The Tax Court found, as stipulated by the parties, that Respondent's reserves, computed on the assumption that deferred and uncollected premiums had been collected, were required by Oklahoma law (Pet. App. A 3a). The Tax Court applied to this case a rule that had been adopted, reluctantly, by the Tax Court in an earlier case to the effect that deferred and uncollected premiums should be included gross in premium income and in assets (Pet. App. A 7a-8a).[14] The Court of Appeals for the Tenth Circuit reversed the Tax Court and ruled that deferred and uncollected premiums should not be included in premium income and should not be included in assets (Pet. App. B 9a).

The questions presented in this case have been the subject of a substantial volume of litigation extending

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[14]The Tax Court in its memorandum opinion in this case cited the 1974 decision of the Tax Court in *Bankers Union Life Ins. Co.*, 62 T.C. 661 (1974). In the latter case, the Tax Court yielded to the decisions of the four Courts of Appeals cited in note 15 *infra*. The Tax Court had originally taken a position consistent with the position of the Respondent in this case in *Western National Life Ins. Co.*, 50 T.C. 285 (1968). This position was later modified by the Tax Court, 51 T.C. 824 (1969), *rev'd*, 432 F.2d 298 (5th Cir. 1970). In the last opinion of the Tax Court on these questions prior to the *Bankers Union* decision, the Tax Court in an opinion of the full court, with two of sixteen judges dissenting, had ruled that at least the loading portion of deferred and uncollected premiums should not be included in premium income and assets. *Western & Southern Life Ins. Co.*, 55 T.C. 1036 (1971), *rev'd*, 460 F.2d 8 (6th Cir. 1972), *cert. denied*, 409 U.S. 1063 (1972).

over the past decade. Five fundamental approaches to these questions have been adopted in the lower courts:

1. Include in premium income and in assets all deferred and uncollected premiums.[15]

2. Include in premium income and in assets deferred and uncollected premiums net of "loading."[16]

3. Include in premium income and in assets deferred and uncollected premiums reduced by the life insurance agents' commissions, state premium taxes and other expenses arising on the receipt of such premiums.[17]

[15]*Franklin Life Ins. Co. v. United States*, 399 F.2d 757 (7th Cir. 1968), *cert. denied*, 393 U.S. 1118 (1969); *Jefferson Standard Life Ins. Co. v. United States*, 408 F.2d 842 (4th Cir. 1969), *cert. denied*, 396 U.S. 828 (1969); *Western National Life Ins. Co. v. Commissioner*, 432 F.2d 298 (5th Cir. 1970); *Western & Southern Life Ins. Co. v. Commissioner*, 460 F.2d 8 (6th Cir. 1972), *cert. denied*, 409 U.S. 1063 (1972); and *Bankers Union Life Ins. Co.*, 62 T.C. 661 (1974).

[16]*Franklin Life Ins. Co. v. United States*, 67-2 U.S.T.C. ¶9515 (S.D. Ill. 1967), *rev'd*, 399 F.2d 757 (7th Cir. 1968), *cert. denied*, 393 U.S. 1118 (1969); *Western National Life Ins. Co.*, 51 T.C. 824 (1969), *rev'd*, 432 F.2d 298 (5th Cir. (1970) (assets only); *Western & Southern Life Ins. Co.*, 55 T.C. 1036 (1971), *rev'd*, 460 F.2d 8 (6th Cir. 1972), *cert. denied*, 409 U.S. 1063 (1972).

[17]The following decisions have allowed deductions for life insurance agents' commissions in the computation of gain from operations: *Great Commonwealth Life Ins. Co. v. United States*, 491 F.2d 109 (5th Cir. 1974); *Federal Life Ins. Co. v. United States*, 527 F.2d 1096 (7th Cir. 1975); *North American Life & Casualty Co. v. Commissioner*, 533 F.2d 1046 (8th Cir. 1976), *aff'g* 63 T.C. 364 (1974); *Midland National Life Ins. Co. v. Commissioner*, 66 T.C. 550 (1976) (premium taxes as well as agents' commissions); *United Life & Accident Ins. Co. v. Commissioner*, 329 F. Supp. 765 (D.N.H. 1971) (expense portion of loading); and *Lincoln National Life Ins. Co. v. United States*, 76-2 U.S.T.C. ¶9772 (Ct. Cl. Trial Judge 1976) (premium taxes as well as agents' commissions). In addition, loading (other than the profit element) was held not includible in assets in *Bankers Life Co. v. United States*, 412 F. Supp. 62 (S.D. Iowa 1976). One district court has allowed a deduction for agents' commissions and state premium taxes relating to deferred and uncollected premiums in the computation of premium income but has denied similar treatment in the computation of assets. *Republic National Life Ins. Co. v. United States*, 77-1 U.S.T.C. ¶9133 (N.D. Tex. 1976).

4. Include no part of deferred and uncollected premiums in premium income and in assets.[18]

5. Include no part of deferred and uncollected premiums in premium income and in assets and reduce life insurance reserves to exclude reserves computed on the assumption that such premiums have been paid.[19]

SUMMARY OF ARGUMENT

Since a life insurance company has no right to receive deferred and uncollected premiums, no part of such premiums should be included in the computation of premium income for a given year. Under normal tax accounting rules an amount is not income for a particular period if the taxpayer has not received and has no right to receive such amount.

Allowance of deductions for increases in life insurance reserves as computed pursuant to state law does not justify the inclusion of deferred and uncollected

[18]*Western National Life Ins. Co.*, 50 T.C. 285 (1968) (assets only), *modified*, 51 T.C. 824 (1969), *rev'd*, 432 F.2d 298 (5th Cir. 1970); the decision of the Court of Appeals for the Tenth Circuit in this case, Pet. App. B 9a.

[19]*Monumental Life Ins. Co. v. United States*, 76-2 U.S.T.C. ¶9787 (Ct. Cl. Trial Judge 1976).

premiums in premium income. There is no requirement in the tax provisions that premium income and life insurance reserves be computed on the basis of the same assumptions and several provisions indicate that changes in life insurance reserves need not be accompanied by adjustments in premium income. The items of deduction and income relating to life insurance reserves and premium income should be treated for tax purposes in the years in which each properly arises under accepted methods of accounting. Normal tax accounting rules do not permit the inclusion in income of any part of deferred and uncollected premiums.

The "loading" portion of deferred and uncollected premiums should not be included in premium income even if the net valuation portion of such premiums were included. This treatment would apply the NAIC annual statement treatment of deferred and uncollected premiums and would be required by Section 818(a) if deferred and uncollected premiums could be included in income under an accepted accounting method. The exclusion or deduction of loading is also necessary to avoid the inclusion in taxable income of amounts that are committed for the payment of expenses arising on the future receipt of deferred and uncollected premiums. In no event could income include these premiums without at least a deduction for such expenses.

Recognition that deferred and uncollected premiums are not properly includible in premium income requires the conclusion that such premiums are likewise not

properly includible in a life insurance company's assets for purposes of computing taxable investment income. As words are ordinarily used the term "asset" would not be applied to amounts that a company has not received and has no right to receive. Moreover, deferred and uncollected premiums should not be included in assets for purposes of computing taxable investment income since deferred and uncollected premiums are not in any sense assets that would be available to yield investment income.

Petitioner is incorrect in arguing that the inclusion of deferred and uncollected premiums in assets is required by any proportional relationship between investment assets and life insurance reserves. In the computation of taxable investment income, the relationships between investment assets and life insurance reserves are complex and demonstrate that Congress did not intend that a proportional relationship between assets and life insurance reserves should guide the treatment of particular items such as deferred and uncollected premiums.

The loading portion of deferred and uncollected premiums should be excluded from assets even if a portion of deferred and uncollected premiums were included. Exclusion of loading is the treatment required by the NAIC annual statement and is also required by the statutory exclusion for assets used in the insurance business. Moreover, the exclusion of loading prevents the overstatement of assets that would arise if deferred

and uncollected premiums were treated as "assets" without any reduction for the expenses that arise as the "assets" are brought into possession. In no event could the expense portion of deferred and uncollected premiums be included in assets.

Applying normal tax accounting standards to exclude deferred and uncollected premiums from premium income and assets does not require any reduction in life insurance reserves. Such reserves, computed pursuant to state law requirements, meet all the requirements for life insurance reserves as set out in Section 801(b). Moreover, any reduction in life insurance reserves as presently computed would be contrary to long-standing practices and would involve a fundamental and adverse change in the computation of life insurance reserves for tax purposes; such a change was clearly not intended by Congress when the present statutory framework for the taxation of life insurance companies was adopted in 1959. The Treasury Department regulation purporting to require a reduction in life insurance reserves if deferred and uncollected premiums are not included gross in premium income and assets either does not support the alternative position advanced by Petitioner with respect to life insurance reserves or is invalid because the regulation exceeds statutory authority.

ARGUMENT

I. NO PART OF DEFERRED AND UNCOLLECTED PREMIUMS SHOULD BE TREATED AS PREMIUM INCOME IN THE COMPUTATION OF A LIFE INSURANCE COMPANY'S UNDERWRITING INCOME.

1. Deferred and uncollected premiums are not includible in premium income under accepted methods of tax accounting.

Deferred and uncollected premiums are not income to a life insurance company for a particular tax year for the simple reason that such premiums have not been received and the life insurance company has no right to receive such premiums. It is a long established and unquestioned principle of tax accounting that amounts are not taxable income in a particular year if a taxpayer has not received and has no right to receive such amounts in that year.

Life insurance companies are required by Section 818(a) to use essentially an accrual method of accounting for tax purposes.[20] Petitioner's regulations specify that "[g]enerally under an accrual method, income is to be included for the taxable year when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy." (Treasury Regulations, Section 1.446-1

[20]Section 818(a)(2) authorizes regulations to permit life insurance companies to use combinations of an accrual method and other permitted methods (other than the cash method).

(c)(ii)).[21] *See Spring City Foundry Co. v. Commissioner*, 292 U.S. 182 (1934). Petitioner concedes (Pet. Br. 10) that for each tax year in question Respondent had not received and had no right to receive deferred and uncollected premiums. Thus, under normal tax accounting rules, these deferred and uncollected premiums were not includible in income.[22]

The deduction allowed for increases in reserves does not justify the inclusion of deferred and uncollected premiums in premium income. One of the deductions allowed in computing a life insurance company's gain from operations is the deduction for the net increase in various types of reserves including life insurance

[21]The other fundamental method of accounting used for tax purposes — the cash method — requires basically that income be included when it is actually or constructively received. *See* Treasury Regulations §1.446-1(c)(i); under Section 818(a) the cash method of accounting may not be used by a life insurance company for tax purposes.

[22]The regulations that purportedly implement Section 809(c)(1) exceed statutory authority when they provide that the "gross amount of *all* premiums" "includes advance premiums, *premiums deferred and uncollected and premiums due and unpaid*, deposits, fees, assessments, and consideration in respect of assuming liabilities under contracts not issued by the taxpayer . . . ." (emphasis supplied). (Treasury Regulations §1.809-4(a)(1)). The italicized words in this quotation do not appear in the statute, which provides that among the items taken into account in computing gain from operations is "[t]he gross amount of premiums and other consideration (including advance premiums, deposits, fees, assessments, and consideration in respect of assuming liabilities under contracts not issued by the taxpayer) . . . ." (Section 809(c)(1)).

reserves.[23] Reserves for Respondent's life insurance policies are computed pursuant to requirements of state law on the assumption that all premiums have been paid in advance on the anniversary date of each policy. However, there is no requirement, either stated in the Internal Revenue Code or indicated in the relevant legislative history, to the effect that the computation of life insurance reserves must govern the computation of premium income.

In fact, several provisions authorize changes in life insurance reserves without a corresponding adjustment to premium income. Thus, Section 810(d)(1) provides that, if there is a change in the basis of determining life insurance reserves or other reserves (for example, a voluntary increase in a company's life insurance reserves, called in the industry a "reserve strengthening"), then the effect of the change as to previously outstanding insurance contracts will be spread out over ten years in computing the deduction for increases in reserves.[24] There is no requirement that premium

[23]Section 809(d)(2) authorizes a deduction for the net increase in reserves described in Section 810(c). The latter section lists six items, one of which is life insurance reserves (Section 810(c)(1)). If there is a net decrease in these reserves, the decrease is treated as an item of income under Section 809(c)(2).

[24]Section 810(d)(1) reads as follows:

"(d) ADJUSTMENT FOR CHANGE IN COMPUTING RESERVES. —

(1) IN GENERAL. — If the basis for determining any item referred to in subsection (c) as of the close of any taxable year differs from the basis for such determination as of the close of the preceding taxable year, then so much of the difference between —

income be adjusted in any way to take into account the change in the basis of computing reserves. A second example again showing that no particular relationship must be maintained between life insurance reserves and premium income, is the authorization in Section 818(c) for the revaluation of reserves computed on a preliminary term basis.[25] Although electing to make this revaluation may result in greater deductions for increases in reserves, there is no requirement that the effect of such revaluation on the deduction for increases in reserves must be accompanied by any related change in the

(A) the amount of the item at the close of the taxable year, computed on the new basis, and

(B) the amount of the item at the close of the taxable year, computed on the old basis,

as is attributable to contracts issued before the taxable year shall be taken into account for purposes of this subpart as follows:

(i) if the amount determined under subparagraph (A) exceeds the amount determined under subparagraph (B), 1/10 of such excess shall be taken into account, for each of the succeeding 10 taxable years, as a net increase to which section 809(d)(2) applies; or

(ii) if the amount determined under subparagraph (B) exceeds the amount determined under subparagraph (A), 1/10 of such excess shall be taken into account for each of the 10 succeeding taxable years, as a net decrease to which section 809(c)(2) applies."

[25]Section 818(c) as in effect for the tax years here at issue reads as follows:

"(c) LIFE INSURANCE RESERVES COMPUTED ON PRELIMINARY TERM BASIS. — For purposes of this part (other than section 801), at the election of the taxpayer the amount taken into account as life insurance reserves with respect to contracts for which such reserves are computed on a preliminary term basis may be determined on either of the following bases:

amount of premium income attributed to the company making such election.

The fact that required methods of computing reserves may result in a particular deduction for a life insurance company in a given tax year thus does not under applicable Internal Revenue Code provisions require a corresponding and offsetting increase in premium income. This result in the case of life insurance companies is consistent with the well-established

(1) EXACT REVALUATION. — As if the reserves for all such contracts had been computed on a net level premium basis (using the same mortality assumptions and interest rates for both the preliminary term basis and the net level premium basis).

(2) APPROXIMATE REVALUATION. — The amount computed without regard to this subsection —

(A) increased by $21 per $1,000 of insurance in force (other than term insurance) under such contracts, less 2.1 percent of reserves under such contracts, and

(B) increased by $5 per $1,000 of term insurance in force under such contracts which at the time of issuance cover a period of more than 15 years, less 0.5 percent of reserves under such contracts.

If the taxpayer makes an election under either paragraph (1) or (2) for any taxable year, the basis adopted shall be adhered to in making the computations under this part (other than section 801) for the taxable year and all subsequent taxable years unless a change in the basis of computing such reserves is approved by the Secretary or his delegate, except that if, pursuant to an election made for a taxable year beginning in 1958, the basis adopted is the basis provided in paragraph (2), the taxpayer may adopt the basis provided by paragraph (1) for its first taxable year beginning after 1958."

The phrase "or his delegate" following the word "Secretary" was deleted by the Tax Reform Act of 1976, Pub. L. No. 94-455, §1906(b)(13)(A). Under Section 810(d)(3), an election under Section 818(c) is not treated as a change to which Section 810(d)(1) applies. *See* note 24 *supra*.

principle that a deduction is to be allowed for the year in which it arises and related income is to be taxed in the year in which it is received or accrued even if the deduction and the income do not fall in the same tax year. Thus in the early case of *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359 (1931), this Court ruled that, in the absence of specific authorization, a taxpayer may not offset losses in one tax year against income from the same transaction in another year. The principles announced in the *Sanford & Brooks* case have been consistently applied by this Court since then. *See Guaranty Trust Co. v. Commissioner*, 303 U.S. 493 (1938); *Security Flour Mills Co. v. Commissioner*, 321 U.S. 281 (1944). The cases of *American Automobile Association v. United States*, 367 U.S. 687 (1961) and *Schlude v. Commissioner*, 372 U.S. 128 (1963), both relating to the tax treatment of advance payments for services, particularly illustrate these principles. In these two cases this Court ruled that income should be taxable in the year received notwithstanding the fact that deductions involved in earning such income were to be taken into account in subsequent tax periods. The fundamental principles applied in the *American Automobile Association* and *Schlude* cases should apply equally whether income precedes deduction or whether, as in this case, the deduction may be viewed as preceding income.

2. "Loading" with respect to deferred and uncollected premiums should not be included in premium

income even if a portion of deferred and uncollected premiums were included in premium income.

If the arguments advanced above were rejected and it were determined that some portion of deferred and uncollected premiums must be included in premium income, additional reasons exist for the exclusion or deduction from premium income of that part of deferred and uncollected premiums which is not taken into account in computing life insurance reserves.

In the annual statement form prepared by the National Association of Insurance Commissioners, deferred and uncollected premiums are included in income and a deduction for loading is allowed. If the inclusion of any part of deferred and uncollected premiums could be deemed consistent with methods of tax accounting permitted for life insurance companies, then an exclusion (or deduction) for loading would appear to be required for tax purposes as it is required in the NAIC annual statements.

Section 818(a), which provides general rules as to methods of tax accounting for life insurance companies, requires that the accounting treatment specified in the NAIC annual statement is to be used when not inconsistent with an accrual method of accounting or a combination of an accrual method with another approved method (other than the cash method) as

permitted by regulations.[26] Should the inclusion of any part of deferred and uncollected premiums in premium income be deemed consistent with an accepted method of accounting as authorized by Section 818(a), the reference in Section 818(a) to the NAIC annual statement would require that no more than deferred and uncollected premiums net of loading be included in premium income.[27]

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[26]Section 818(a) as in effect for the tax years here at issue reads as follows:

"(a) METHOD OF ACCOUNTING. — All computations entering into the determination of the taxes imposed by this part shall be made —

(1) under an accrual method of accounting, or

(2) to the extent permitted under regulations prescribed by the Secretary or his delegate, under a combination of an accrual method of accounting with any other method permitted by this chapter (other than the cash receipts and disbursements method).

Except as provided in the preceding sentence, all such computations shall be made in a manner consistent with the manner required for purposes of the annual statement approved by the National Association of Insurance Commissioners."

The phrase "or his delegate" in paragraph (2) was deleted by the Tax Reform Act of 1976, Pub. L. No. 94-455, §1906(b)(13)(A).

[27]The NAIC annual statement treatment could be applied for tax purposes by allowing a deduction for loading with respect to deferred and uncollected premiums under the general provision authorizing "all other deductions allowed under this subtitle for purposes of computing taxable income to the extent not allowed as deductions in computing investment yield." (Section 809(d)(11), formerly Section 809(d)(12) until redesignated by the Tax Reform Act of 1976, Pub. L. No. 94-455, §1901(a)(98)). Alternatively, the loading portion of deferred and uncollected premiums could be excluded from gross premiums under Section 809(c)(1); the Tax Court employed the latter approach in *Western & Southern Life Ins. Co., supra* note 16.

Failing to exclude at least loading from premium income would entail the anomalous result that a life insurance company would have greater premium income for tax purposes when premiums were deferred and uncollected than when they were collected. For example, assume two life insurance companies, A and B, identical in all respects except that $100 of premium income of A is deferred and uncollected whereas the equivalent $100 of premium income is received by B before the end of the year. Assume further that loading on the premiums in question is $20 and that such loading just covers agents' commissions, state premium taxes, and other expenses arising on receipt of such premiums. If deferred and uncollected premiums are included in taxable income but no exclusion or deduction is allowed for loading, Company A would show, with respect to the deferred and uncollected premiums, premium income of $100. In contrast, Company B would show premium income with respect to equivalent premiums of only $80 because Company B would be able to claim deductions for the $20 of expenses incurred in receiving the premiums in question. It is an absurd result for a life insurance company, or indeed for any taxpayer to be deemed to have a larger amount of income in a particular year if the income is not received than would have been the case if the income had been received.

The results of including gross deferred and uncollected premiums in premium income as described above would be directly contrary to expressed Congressional

intent in the case of small, growing life insurance companies. For a small but growing life insurance company, the amount of deferred and uncollected premiums will in most cases be relatively substantial and loading (particularly the portion allocable to life insurance agents' commissions on new policies) will be a large part of such deferred and uncollected premiums. In such circumstances, taxing deferred and uncollected premiums without excluding or deducting loading would require payment of substantial taxes on amounts that had not been received and would never be received as net income by the small company. Such a result is directly contrary to expressed Congressional intent that small companies should not show inflated figures for gain from operations. Thus, the Senate Finance Committee Report on the 1959 legislation indicates Congressional expectations as to the premium income of small, growing life insurance companies as follows:

> ". . . for many other companies, particularly small, new and growing life insurance companies, having underwriting losses rather than gains, the inclusion of this underwriting element in the tax base means a lesser, rather than a greater tax. The small, new, and growing life insurance companies are particularly likely to have underwriting losses because of the initial costs which they incur (such as agents' commissions) in placing new policies on their books. Both the House and your committee's bill are particularly liberal in these cases since they allow the offset of these underwriting losses in full against taxable investment income (subject to certain restrictions as to the deduction of policyholder dividends, etc.) and

> do not require the 50 percent reduction in such losses which would be made if they were gains."[28]

This expectation could not be fully realized if deferred and uncollected premiums including loading were held to be premium income for small but growing companies.

The fact that loading may cover not only expenses of acquiring deferred and uncollected premiums but also profit in the case of stock companies and dividends in the case of participating policies does not justify including loading on deferred and uncollected premiums in premium income. In the first place the profit or dividend element of loading will often be only a small part of loading. Moreover, any part of loading that may be deemed to be profit should not be included in premium income since such "profit" is only potential and has not yet been earned. As for dividends to policyholders that might in some cases be deemed to be a part of loading, such dividends would be deductible (subject to overall limits)[29] in the computation of gain from operations; it would therefore appear appropriate to include the dividend portion of loading in premium income in the year that the loading is received and is

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[28] S. Rep. No. 291, 86th Cong., 1st Sess. 7 (1959).

[29] A deduction is allowed for dividends to policyholders under Section 809(d)(3). This deduction and deductions under Sections 809(d)(5) and 809(d)(6) (relating to certain nonparticipating insurance contracts and certain accident and health and group life insurance contracts) taken together are limited under Section 809(f) to $250,000 plus the amount by which gain from operations (computed without these deductions) exceeds taxable investment income.

available to pay dividends to policyholders rather than in the prior year.

Thus, if any amount of deferred and uncollected premiums is to be included in a life insurance company's premium income, the loading portion of deferred and uncollected premiums should in any event be excluded or deducted.[30] It should be noted that the United States Tax Court reached precisely this conclusion in an opinion that was reviewed by the full sixteen-member court and was supported by fourteen of the sixteen judges. *See Western & Southern Life Ins. Co.*, 55 T.C. 1036 (1971), *rev'd*, 460 F.2d 8 (6th Cir. 1972), *cert. denied*, 409 U.S. 1063 (1972).

3. In no event should deferred and uncollected premiums be included in premium income without at least a deduction for the expenses of acquiring such premiums.

If this Court were to reject the arguments that deferred and uncollected premiums may not be included in premium income and that in any event loading may not be included, a deduction should nonethe-

[30]Such a result would even appear to be in accord with Petitioner's assertion, which Respondent believes to be erroneous, that assumptions used in the computation of life insurance reserves must be used in the computation of premium income. The only assumption as to deferred and uncollected premiums made in the computation of life insurance reserves is that the net valuation portion of deferred and uncollected premiums has been received by year-end; no assumption is made as to the receipt of loading. Hence there is no occasion even on Petitioner's theory to assume the receipt of loading in the computation of premium income.

less be allowed for the expenses that are necessarily incurred by a life insurance company in the receipt of deferred and uncollected premiums. The same contrary-to-fact assumption that would justify the inclusion of deferred and uncollected premiums in income should also be grounds for allowing the concomitant deductions. Such deductions would thus be allowed for life insurance agents' commissions, state premium taxes, and any other direct expenses of acquisition that might be shown in a particular case.[31] It is noteworthy that even those courts that have required the inclusion of deferred and uncollected premiums in premium income without any exclusion or deduction for loading have permitted a deduction for certain expenses related to deferred and uncollected premiums in all reported cases in which the question has been presented.[32]

II. NO PART OF DEFERRED AND UNCOLLECTED PREMIUMS SHOULD BE INCLUDED IN ASSETS FOR PURPOSES OF COMPUTING A LIFE INSURANCE COMPANY'S TAXABLE INVESTMENT INCOME.

1. Deferred and uncollected premiums are not assets that may be included in any amount in computing a life insurance company's earnings rate.

[31]If this Court were to rule that deferred and uncollected premiums should be included in premium income except for the expenses of acquiring such premiums, it would be necessary for this case to be remanded to the Tax Court for findings with respect to the amount of such expenses. *Cf. Commissioner v. Gordon*, 391 U.S. 83, 95 n.8 (1968).

[32]These decisions are cited in note 17 *supra*.

Petitioner concedes (Pet. Br. 10) that Respondent had no right to receive any part of deferred and uncollected premiums at the end of any tax year. If these premiums were not ultimately paid, the only consequences would have been that the life insurance in question would lapse after a specified period. As words are normally used, the term "asset" would not be applied to a possibility of future payment to a person who had no right to receive such payment. Hence, deferred and uncollected premiums should not be included as assets in the computation of a life insurance company's taxable investment income.[33]

The exclusion of deferred and uncollected premiums from the computation of taxable investment income is thus fully justified by the fact that these premiums are simply not assets in any sense.[34] However, such exclusion would also be required even if deferred and uncollected premiums were deemed to be in some sense assets in view of the fact that deferred and uncollected premiums do not constitute an asset from which invest-

[33]Generally words in tax provisions are interpreted to have their usual non-tax meanings. *See Malat v. Riddell*, 383 U.S. 569 (1966).

[34]It is noteworthy in this regard that Section 805(b)(4), which defines the term "assets" as used in the provisions governing the computation of taxable investment income, defines the term to refer only to assets "of the company . . . ." Since a life insurance company has no right to receive deferred and uncollected premiums, such premiums are certainly not in any sense assets "of the company". Hence the inclusion of deferred and uncollected premiums in the computation of taxable investment income is not authorized by the literal terms of the statute even if a very expansive scope were accorded the term "assets."

ment earnings might be derived.[35] If an asset at all, deferred and uncollected premiums are a notional asset that is used in the conduct of the insurance business. Such an asset would be excluded from the computation of taxable investment income by Section 805(b)(4), which specifies the assets that are to be used in computing a life insurance company's earnings rates. Section 805 (b)(4) specifically excludes from the computation of earnings rates "real and personal property (excluding money) used by [the company] in carrying on an insurance trade or business."

Treating deferred and uncollected premiums as not includible in assets used in the computation of earnings rates is consistent with evident Congressional intent that the earnings rate on a life insurance company's investment assets should be used in determining the policyholders' share of items of investment income. Thus, the Subcommittee on Internal Revenue Taxation of the House Committee on Ways and Means, in outlining the computation of a company's earnings rate under an earlier version of the provisions ultimately adopted in 1959, described the assets used in the computation as follows:

[35]Frequently a somewhat higher premium is charged when premiums are not paid annually and in advance. However, the higher premium offsets higher administrative costs involved in deferred and uncollected premiums and no part of the higher premium is considered investment income. *See* J. Maclean, *Life Insurance*, 107-08 (9th ed. 1962).

> "'Assets' in effect are defined as those held for investment purposes or for gain in a trade or business other than the insurance business."[36]

In the course of the further work on the provisions that were ultimately enacted in 1959, there was no change in this concept. The Report of the Senate Finance Committee on the provisions ultimately enacted described the computation of the policyholders' share of investment income in terms of the application of each company's average "investment earnings rate".[37] Indeed, the concept of an "earnings rate" would itself appear to carry with it the concept that such rate is to be determined by dividing investment earnings by the assets available to yield such earnings. Thus, the legislative history and the statutory language both support the conclusion that deferred and uncollected premiums, which yield no investment income, should not in any case be included in assets for purposes of computing a life insurance company's earnings rates.[38]

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[36]Subcommittee on Internal Revenue Taxation, House Committee on Ways and Means, *Report on the Taxation of Life Insurance Companies* 12 (December 31, 1958).

[37]S. Rep. No. 291, 86th Cong., 1st Sess. 5 (1959). In the discussion of the term "property used in carrying on an insurance business" in connection with provisions relating to capital gains, the Report contrasts property used in the insurance business with "so-called investment assets from which interest, rents, dividends, and royalties are derived. . . ." S. Rep. No. 291, 86th Cong., 1st Sess. 70 (1959).

[38]If deferred and uncollected premiums could be treated as assets in any sense, they would under Section 805(b)(4) add nothing to the total of a life insurance company's assets for purposes of computing earnings rates since such "assets" would have a zero adjusted basis. The second sentence of Section 805(b)(4) directs that the amount attributable to any asset other than real property or stock is to be "the adjusted basis of such asset for purposes of determining gain on sale or other disposition." The unadjusted basis of an asset is cost under Section 1012 and no adjustments under Section 1016 are relevant in these circumstances. Property that is being received as income has a cost basis to the recipient at any point in time no greater than the amount that must have been included in the recipient's income to that point. *Cf. Bennet v. Helvering*, 137 F.2d 537 (2d Cir. 1943). As was shown at pages 13-14 above, under normal tax accounting methods, no part of deferred and uncollected premiums may be included in a life insurance company's taxable income for a given year; hence, if deferred and uncollected premiums could be considered to be an asset of a life insurance company, the adjusted basis of such deferred and uncollected premiums "asset" at year-end would be zero.

The fact that life insurance reserves are computed on the assumption that deferred and uncollected premiums have been received does not justify including such premiums in assets. Reserves for Respondent's life insurance policies are computed on the assumption that all premiums are paid annually in advance on the anniversary date of each policy. As is discussed more fully at pages 40-46 below, this treatment was adopted over one hundred years ago and has been applied consistently since that time. The reserves thus computed are required by state law and meet all the requirements for life insurance reserves set forth in Section 801(b). But contrary to the position taken by Petitioner, the computation of life insurance reserves pursuant to state law does not require that deferred and uncollected premiums be treated as investment assets.

The Brief for the Petitioner sets forth several times a simple ratio — $\frac{\text{Reserves}}{\text{Assets}}$ — as a proposed guide to the treatment of deferred and uncollected premiums. As is shown below, this ratio cannot be derived from the statutory provisions. However, even if this ratio were a part of the law, such ratio would give no guidance as to what is to be included in "Reserves" and in "Assets". Petitioner begs the question by assuming a certain initial content for "Reserves" and "Assets" and then arguing that a "change" in one element must be accompanied by a "change" in the other element.

Petitioner's argument from the $\frac{\text{Reserves}}{\text{Assets}}$ ratio must also be rejected because the suggested ratio does not appear in the tax provisions applicable to life insurance companies and more importantly cannot be derived from the statutory provisions. Petitioner's equation (2) (at Pet. Br. 6 and 40), is as follows:

"(2) Earnings Rate x Reserves = Tax Exclusion". This equation should however read as follows to reflect accurately the terms of Section 805:

Lower of Current or Five-Year Average Earnings Rate	x	Adjusted Current Reserves	=	Tax Exclusion[39]

[39]Petitioner notes these complexities in Pet. Br. 5-6 nn.5, 6 and 39 nn.28, 29; however, the formulae and discussion in the text of the Brief for the Petitioner, at Pet. Br. 6-7, 40-41, do not reflect these complexities and hence the formulae and discussion are in Respondent's view misleading. An additional complexity

The adjusted reserves figure is obtained under Section 805(c)(1) (the "Menge Formula"), which basically provides that the reserves are to be decreased 10% for each one percentage point by which the company's earnings experience (the lower of current or five-year average) exceeds the average rate of interest assumed in calculating reserves (if the average rate of interest assumed in computing reserves exceeds the earnings experience then reserves are to be increased on the same basis).

Because of the operation of the Menge Formula, there is no simple proportional relationship between life insurance reserves and assets. The relationship between life insurance reserves and assets for a given year is never one of simple proportionality but the relationship is most direct when the current earnings rate rather than a five-year average rate is used in the computation (this is the case when the current earnings rate is lower than the five-year average). However, even in this less complex case, the proposed ratio of reserves to assets does not explain the actual relationship since changes in assets cause changes in the current earnings rate that in turn cause changes in the adjustment to reserves under the Menge Formula. If a proportionality existed, the Tax Exclusion would vary

is that the "Tax Exclusion" shown is only the part of "policy and other contract liability requirements" relating to life insurance reserves other than pension plan reserves. *See* Sections 805(a), 805(c)(1); Pet. Br. 40 n.30.

directly with the amount of "Reserves" and inversely with the amount of "Assets" as asserted by the Petitioner (Pet. Br. 41). But, although a direct proportional relationship to the Tax Exclusion does exist in the case of life insurance reserves, no inverse proportional relationship exists between assets and the Tax Exclusion. At certain realistic earnings rates, an increase in assets will result in an increase rather than a decrease in the Tax Exclusion.[40] Such a result is totally inconsistent with the proportional relationship asserted by Petitioner.

In cases where the current earnings rate is higher than the five-year average earnings rate of a life insurance company, the five-year average earnings rate is employed under Section 805(b)(1) and the relationship between life insurance reserves and assets for a given year is even more complex. When a five-year average earnings rate is used, the equations presented by Petitioner would be restated as follows:

(1) Five-Year Average of $\frac{\text{Investment Yield}}{\text{Assets}}$ = Adjusted Earnings Rate

(2) Adjusted Earnings Rate X Current Reserves (Adjusted under Menge Formula) = Tax Exclusion

[40]For example, such result would occur when the average interest rate assumed in a life insurance company's computation of reserves was 3% and the current earnings rate used in the computation of the Tax Exclusion was 7%. More generally such result will arise in any case where the earnings rate used in the computation is greater than five percent plus one-half the average interest rate assumed in the computation of reserves. *See* Fraser, *Income Tax and Reserve Valuation*, The Actuary, November 1972, at 4.

(3) Five-Year Average of $\frac{\text{Investment Yield}}{\text{Assets}}$ X Current Reserves (Adjusted under Menge Formula) = Tax Exclusion

or

Weighted[41] Five-Year Average Investment Yield X $\frac{\text{Current Reserves (Adjusted under Menge Formula)}}{\text{Five-Year Average Assets}}$ = Tax Exclusion

Thus, in the common circumstance of generally rising investment earnings rates from year to year, the statutory scheme for computing taxable investment income requires if anything a comparison between the current year's life insurance reserves (as adjusted to take into account earnings experience over five years) and a figure for assets that would reflect only in a five-year average any deferred and uncollected premiums that might under Petitioner's theory be included in assets for the current year.

Further support for the conclusion that, in the computation of taxable investment income, reserves and assets should be computed separately (and without the application in one computation of assumptions used in the other computation) is found in the several tax

[41]Because of the use in the tax provisions of a simple average of earnings rates for five years, equation (3) may be restated in terms of a relationship between Current Reserves (Adjusted under Menge Formula) and Five-Year Average Assets only if the figure for the Five-Year Average Investment Yield is calculated on a "weighted" basis giving proportionally greater or lesser weight to investment yield for each year as the figure for average assets exceeds or is less than the actual figure for assets for the particular year.

provisions requiring or authorizing adjustments in reserves. The only specific statutory provision calling for a relation between life insurance reserves and assets of a life insurance company is the "Menge Formula" discussed above; such formula requires an adjustment in reserves to take into account a company's earnings experience on its investment assets and as shown above the formula in no sense mandates any simple, proportional relationship between life insurance reserves and assets. In addition, in Section 806(b) it is specifically recognized that there may be changes in the basis of computing life insurance reserves for purposes of computing taxable investment income; such section specifies that any such change is to be applied at the beginning of the next taxable year but this provision requires no change in a life insurance company's assets to accompany the change in the computation of reserves.[42] The same lack of requirement for any adjustment in assets to correspond to adjustments in life insurance reserves is found with respect to the authorization in Section 818(c) for an increase in reserves that have been computed on a preliminary term

[42]Section 806(b) reads as follows:

"CHANGE OF BASIS IN COMPUTING RESERVES. — If the basis for determining the amount of any item referred to in section 810(c) as of the close of the taxable year differs from the basis for such determination as of the beginning of the taxable year, then for purposes of this subpart the amount of such item —

(1) as of the close of the taxable year shall be computed on the old basis, and

(2) as of the beginning of the next taxable year shall be computed on the new basis."

In the case of certain transfers of liabilities to another taxpayer, Section 806(a) requires adjustments, on a daily basis, to a life insurance company's life insurance reserves and assets to reflect the amounts transferred.

basis[43]; such authorization for an adjustment in reserves imposes no requirement that there be any adjustment in assets.

Thus, there is no statutory support for Petitioner's position that the inclusion of an amount in reserves requires the inclusion of some related amount in assets.[44] There is no requirement for such treatment stated in the provisions applicable to life insurance companies and there is nothing in the legislative history of the tax provisions to indicate that Congress intended for such an approach to be imposed on life insurance companies. In sum, nothing whatever indicates that Congress intended that a life insurance company should have imputed to it nonexistent assets merely because

[43]*See* note 25 *supra*.

[44]Of course, even if Petitioner were correct as to the existence of some simple proportional relationship to be maintained between life insurance reserves and assets, Petitioner would still need to show that the relation between the net valuation portion of deferred and uncollected premiums and gross deferred and uncollected premiums has any conceptual relationship to the alleged relation between reserves and assets. Such conceptual relationship has not been shown by Petitioner and would not appear to exist since the difference between the net valuation portion and gross deferred and uncollected premiums is loading, which does not have any necessary invariant relationship to life insurance reserves or to assets.

of a life insurance company's method of computing its life insurance reserves under applicable state law.

2. "Loading" with respect to deferred and uncollected premiums should not be included in assets even if a portion of deferred and uncollected premiums were included in assets.

If the arguments advanced above were rejected and it were determined that some portion of deferred and uncollected premiums must be included in assets, in any event the loading with respect to such premiums should not be included in investment assets. The additional reasons for excluding the "loading" portion of deferred and uncollected premiums from assets essentially parallel the reasons given at pages 18-24 above for the exclusion of "loading" from premium income.

The exclusion of loading from assets as required in the NAIC annual statement form should be applied for tax purposes if any part of deferred and uncollected premiums is to be included in assets for purposes of the computation of taxable investment income. Such treatment would appear to be required by Section 818(a), which as noted above requires computations to be made in a manner consistent with the NAIC annual statement treatment except when the NAIC annual statement deviates fundamentally from the accrual method of accounting or a combination of methods of accounting permitted by regulations. Respondent's principal position is that under an accrual or any other permitted method of accounting no part of deferred and uncollected premiums may be included in assets. However, if the inclusion of deferred and uncollected premiums in assets can be deemed to be permitted by Section 818(a), then that section would require application of the NAIC annual statement approach, which would include in assets deferred and uncollected premiums net of loading.[45]

The exclusion of loading from assets used in the computation of earnings rates is also required by the statutory exclusion from such assets of personal property other than money used by a life insurance company in carrying on the insurance business (Section 805(b)(4)). If the loading portion of deferred and uncollected premiums could in any sense be viewed as an asset, loading must necessarily be viewed, not as an investment asset, but rather as an asset inextricably bound up with carrying on the insurance business.[46] Hence, even if loading were an asset in an accounting

[45]This treatment would even seem to be in accord with Petitioner's assertion, which Respondent believes to be incorrect, that assumptions used in the computation of life insurance reserves must be used in the computation of assets. The only assumption as to deferred and uncollected premiums made in the computation of life insurance reserves is that the net valuation portion of such premiums has been received by year-end; the receipt of loading is not assumed. Hence even if all assumptions involved in the computation of life insurance reserves were to be automatically applied to all asset computations, no more than the net valuation portion of deferred and uncollected premiums could be included in assets.

[46]*Cf. Bankers Life Co. v. United States*, 412 F.Supp. 62 (S.D. Iowa 1976), in which the court ruled that all loading except any margin for profit was property used in the insurance business which should be excluded from the computation of earnings rates.

sense, it would not be an asset under Section 805(b)(4) for purposes of computing taxable investment income.[47]

A final reason for not including the loading portion of deferred and uncollected premiums in assets for purposes of computing a life insurance company's earnings rates is that the inclusion of loading would cause a life insurance company to show greater assets for tax purposes to the extent that premiums were deferred and uncollected rather than received by the end of a particular tax year. The tax provisions should not be interpreted to yield such an irrational result.[48]

3. In no event should deferred and uncollected premiums be included in assets without at least a reduction for the expenses of bringing such premiums into possession.

[47]Moreover, as the full exclusion of deferred and uncollected premiums from income would entail a like exclusion from assets (see note 38 *supra*), so the exclusion of the loading portion of such premiums from income should entail the exclusion of such loading from assets. For reasons set out at pages 18-24 above, if any part of deferred and uncollected premiums were included in premium income the loading portion should in any event be excluded from income. Thus, if loading were an asset at all, it would have a zero adjusted basis because it would not be included in taxable income; loading would therefore under Section 805(b)(4) be included at a zero amount in the computation of a life insurance company's earnings rate.

[48]Of course, should deferred and uncollected premiums net of loading be included in assets, assets would be greater if particular premiums were actually collected before year-end to the extent (if any) that loading exceeded the expenses of collection. Such result does not however appear unreasonable in view of the fact that a life insurance company would in fact have greater assets if premiums were collected rather than remaining uncollected at the end of the year.

If, in spite of the arguments advanced above, deferred and uncollected premiums including the loading portion were held to be includible in assets for purposes of computing earnings rates, life insurance companies should in any event be allowed to reduce the deferred and uncollected premiums "asset" by the expenses that must be incurred to bring this "asset" into possession. Such an adjustment would at least avoid the imputation to life insurance companies of greater assets at year-end when premiums are uncollected than when they are actually received.[49]

III. THE EXCLUSION OF DEFERRED AND UNCOLLECTED PREMIUMS FROM PREMIUM INCOME AND FROM ASSETS DOES NOT JUSTIFY ANY REDUCTION IN LIFE INSURANCE RESERVES.

Petitioner has taken the alternative position that if deferred and uncollected premiums are not included in full in premium income and assets, then life insurance reserves must be reduced. For the reasons stated below, such proposed reduction in reserves would be unjustified and would be contrary to expressed Congressional intent with respect to the effect of the present tax provisions on life insurance reserves.

1. All reserves required by law for life insurance policies as to which there are deferred and uncollected

[49]As was indicated in note 31 *supra*, a remand to the Tax Court would be necessary if this Court were to rule that deferred and uncollected premiums net of expenses must be included in assets for purposes of computing earnings rates.

premiums are "life insurance reserves" under Section 801(b).

Life insurance companies including Respondent have for many years computed their reserves as required by state law on the assumption that premiums as to all outstanding policies at the end of a particular year have been paid in advance on the anniversary date of each policy. Reserves as so computed are reported each year on the NAIC annual statements and are of prime concern to state regulatory authorities in the protection of policyholders. As Petitioner points out (Pet. Br. 34-36), the present method of computing reserves was authoritatively adopted initially at the First Session of the National Insurance Convention in 1871 and has been employed consistently since that time.

Life insurance reserves as presently calculated meet all the requirements for life insurance reserves set forth in Section 801(b) of the Internal Revenue Code. They are "computed or estimated on the basis of recognized mortality or morbidity tables and assumed rates of interest" (Section 801(b)(1)(A)). They are amounts "which are set aside to mature or liquidate, either by payment or reinsurance, future unaccrued claims arising from life insurance, annuity, and noncancellable health and accident insurance contracts (including life insurance or annuity contracts combined with noncancellable health and accident insurance) involving, at the time with respect to which the reserve is com-

puted, life, health, or accident contingencies." (Section 801(b)(1)(B)). And they are "required by law" (Section 801(b)(2)).[50] In addition, the computation of reserves on the assumption that the net valuation portions of deferred and uncollected premiums have been paid is consistent with the NAIC annual statement computation mandated by Section 818(a).

2. To exclude reserves relating to deferred and uncollected premiums from life insurance reserves for tax purposes would create a fundamental change in the tax treatment of life insurance companies contrary to the intent of Congress in the 1959 enactment of the present tax provisions.

When the present tax treatment of life insurance companies was adopted by Congress in 1959, the reports of the House Ways and Means Committee and the

[50]It should be noted that in the absence of specific statutory authority for the treatment of life insurance reserves, such reserves would not be given tax effect since they are set aside to liquidate future unaccrued claims. *See Brown v. Helvering*, 291 U.S. 193 (1934). The significance of the specific statutory treatment of life insurance reserves is highlighted by the fact that the original version of the Internal Revenue Code of 1954, ch. 736, 68A Stat. 3 (1954), contained a provision denominated Section 462, 68A Stat. 158, that allowed to taxpayers generally a new deduction for additions to reserves for certain estimated expenses. This provision allowed a deduction where none had been allowed before. *See* H.R. Rep. No. 1622, 83d Cong., 2d Sess. 63-64 (1954); S. Rep. No. 1337, 83d Cong., 2d Sess. 49 (1954). Because of the unexpectedly heavy adverse revenue effect of this provision it was repealed with retroactive effect by Pub. L. No. 74, 69 Stat. 134 (1955). *See* H.R. Rep. No. 293, 84th Cong., 1st Sess. (1955); S. Rep. No. 372, 84th Cong., 1st Sess. (1955).

Senate Finance Committee on the legislation[51] gave no indication whatever that Congress intended any change in the traditional computation of life insurance reserves except as to specific issues which were thoroughly discussed in the committee reports--for instance, the "Menge Formula" relating earnings experience to earnings assumed in the computation of reserves, the revaluation of reserves computed on a preliminary term basis authorized by Section 818(c), and the exclusion from life insurance reserves of "deficiency reserves".[52] The term "reserves" is used hundreds of times in the committee reports on the 1959 legislation without the slightest hint that any fundamental change was intended in the long-accepted treatment of life insurance reserves under earlier tax provisions. The committee reports specifically state that the definition of life insurance reserves is unchanged from prior law except for refinements not here pertinent.[53] Moreover,

[51] H.R. Rep. No. 34, 86th Cong., 1st Sess. (1959); S. Rep. No. 291, 86th Cong., 1st Sess. (1959).

[52] *See* H.R. Rep. No. 34, 86th Cong., 1st Sess. 11, 17-18, 22, 26, 42-43 (1959); S. Rep. No. 291, 86th Cong., 1st Sess. 10, 15-16, 19, 30-32, 42, 73-74 (1959).

[53] H.R. Rep. No. 34, 86th Cong., 1st Sess. 22 (1959); S. Rep. No. 291, 86th Cong., 1st Sess. 42 (1959). Thus the Senate Finance Committee Report, in explaining the definition of "life insurance reserves" states that "[t]his subsection, as in the House bill, defines life insurance reserves for purposes of part I of subchapter L of chapter 1 of the 1954 Code. In general, the definition is the same as that contained in Section 801(b) of the House bill and existing law." The explanation then goes on to discuss the treatment of reserves relating to policies issued by certain voluntary employees' beneficiary associations and by assessment life insurance companies, and the exclusion of "deficiency reserves" from life insurance reserves. S. Rep. No. 291, 86th Cong., 1st Sess. 42 (1959).

the possibility that the provisions enacted in 1959 might be interpreted to control life insurance reserves computed in accord with state law requirements was specifically rejected on the floor of the House of Representatives by Congressman Mills, the Chairman of the House Committee on Ways and Means.[54]

The absence of any evidence of an intention on the part of Congress to change the basic treatment of life insurance reserves with the enactment of the Life Insurance Company Income Tax Act of 1959 is of funda-

[54] "Mr. Simpson of Pennsylvania. . . . There is a matter of great importance on which I am sure the gentleman from Arkansas [Mr. Milis], the chairman, holds an opinion which coincides with mine; namely: that the committee has no intention of placing jurisdiction of the management of insurance company reserves within the hands or powers of the Commissioner of Internal Revenue. Specifically, I refer to section 806 of the bill before us. This section of the bill relates to a change of basis in computing reserves. I ask whether it is intended that permission to change the basis requires approval of the Secretary of the Treasury or his delegate as provided by section 446(e) of the code?

"Mr. Mills. Certainly, it is not the intention of the chairman that that be required. I think I can speak without fear of contradiction and say it is not the intention of the committee. We are trying to preserve as best we can in this bill the management of this industry in the hands of the State regulatory agencies and not to change in any way that situation so as to turn over to the Commissioner of Internal Revenue, the Secretary of the Treasury, or anyone else in Washington the regulatory authority.

"Mr. Simpson of Pennsylvania. I thank the chairman.

"Mr. Mills. We are endeavoring to tax what we think is the true income of the insurance companies.

"Mr. Simpson of Pennsylvania. I thank the gentleman, and say that I agree with him."

105 Cong. Rec. 2576-77 (1959) (proceedings on February 18, 1959).

mental importance since there is no question that the inclusion of reserves on all policies in force including those with respect to which there are deferred and uncollected premiums had been accepted for tax purposes for approximately forty years when the 1959 provisions were adopted. From 1921 to 1941, the amount of each life insurance company's reserves was an important factor in determining a company's federal income tax liabilities (generally a specified earnings rate was applied to each life insurance company's life insurance reserves to determine that company's deduction for policyholder requirements in computing taxable investment income).[55] For the years from 1942 to 1950, total reserves for the life insurance industry, including reserves for policies as to which there were deferred and uncollected premiums, played a part in computing industry-wide reserve interest requirements used in determining the portion of investment income subject to tax.[56] From 1951 to 1957, the amount of life insurance reserves ceased to have an important place in the com-

[55]*See* Revenue Act of 1921, ch. 136, §§242-247, 42 Stat. 227, 261-64 (1921); Revenue Act of 1924, ch. 234, §245(a), 43 Stat. 253, 289 (1924); Revenue Act of 1926, ch. 27, §245(a), 44 Stat. 9, 47 (1926); Revenue Act of 1928, ch. 852, §203(a), 45 Stat. 791, 842 (1928); Revenue Act of 1932, ch. 209, §203(a), 47 Stat. 169, 224 (1932); Revenue Act of 1934, ch. 277, §203(a), 48 Stat. 680, 732 (1934); Revenue Act of 1936, ch. 690, §203(a), 49 Stat. 1648, 1710 (1936); Revenue Act of 1938, ch. 289, §203(a), 52 Stat. 447, 523 (1938); Internal Revenue Code of 1939, ch. 2, §203(a), 53 Stat. 1, 71 (1939).

[56]*See* Internal Revenue Code of 1939, §§202, 203, as amended by Revenue Act of 1942, ch. 619, §163(a), 56 Stat. 798, 867, (1942).

putation of taxable investment income[57] but continued to be crucial in determining a company's status as a life insurance company.[58] During all these years, reserves computed on the assumption that all premiums had been paid at the policy anniversary date were included without question in life insurance reserves.

The question as to the proper tax treatment of such reserves under prior laws was settled by a 1918 decision of the Federal District Court for the District of New Jersey in the case of *Prudential Ins. Co. of America v. Herold*, 247 Fed. 681 (D.N.J. 1918). This decision was ultimately accepted by the federal tax authorities and hence the question was never again litigated in a reported case. Three years after that decision, in 1921, the Bureau of Internal Revenue announced the position that reserves relating to deferred and uncollected premiums should be included in reserves for purposes of computing a life insurance company's deductions and should also be taken into consideration in determining a life insurance company's invested capital for excess

[57]*See* Internal Revenue Code of 1939, §203A, added by Revenue Act of 1951, ch. 521, §336(b), 65 Stat. 452, 508 (1951), amended by Pub. L. No. 468, §§[1](b), 2, 66 Stat. 444 (1952), amended by Technical Changes Act of 1953, §105, 67 Stat. 315, 616 (1953); Internal Revenue Code of 1954, ch. 736, §§801-807, 68A Stat. 3, 255-59 (1954); Internal Revenue Code of 1954, §§804-805, as amended by Pub. L. No. 429, §2, 70 Stat. 36, 41-44 (1956).

[58]*See* Internal Revenue Code of 1939, §201(b), as amended by Revenue Act of 1942, ch. 619, §163(a), 56 Stat. 798, 867 (1942); Internal Revenue Code of 1954, ch. 736, §801, 68A Stat. 3, 255 (1954); Internal Revenue Code of 1954, §801(a), as amended by Pub. L. No. 429, §2, 70 Stat. 36 (1956).

profits tax purposes.[59] This position remained unchanged when the first statutory definition of life insurance reserves was added by the Revenue Act of 1942. The committee reports on the 1942 statutory definition state that the new definition was "substantially that contained for many years in the regulations" except for the addition of certain particular requirements that are not pertinent here.[60] No significant change was made in the statutory definition added

[59]"8. Reserve funds of life insurance companies. — Generally speaking, Items 7, 8, and 9 of the liability page of the annual statement, convention edition, will be considered reserves as contemplated by the statute. . . . .

* * * *

"14. Uncollected and deferred premiums. — Uncollected and deferred premiums can not reduce reserves. The legal reserves, the net addition to which is deducted from gross income, can not be reduced by the net uncollected and deferred premiums inasmuch as such premiums have not been included as premium income. It also logically follows that the same reserves, upon which the deduction of the net addition is computed for purposes of the income tax, should be taken into consideration in determining invested capital for excess-profits tax purposes. The regulations covering the adjustments by way of additions to, or deductions from, invested capital, applicable to corporations in general, will be observed and followed by insurance companies."

Treasury Department, Bureau of Internal Revenue, *Bulletin "H" — Income Tax Rulings Peculiar to Insurance Companies* 7, 9 (1921).

[60]*See* H.R. Rep. No. 2333, 77th Cong., 2d Sess. 109 (1942); S. Rep. No. 1631, 77th Cong., 2d Sess. 145 (1942). The latter Committee report discusses the new definition and the differences between the House and Senate versions in the following terms:

"Section 201(c)(2) is new and defines the term 'life insurance reserves.' The definition is substantially that contained for many years in the regulations with the addition that the reserves must be based on recognized mortality or morbidity tables, the health and accident reserves must be noncancelable, and unpaid loss reserves on such health and accident contracts are included if computed on a discount basis. The

in 1942 until the present version of Section 801(b) was enacted in 1959. As has been shown above, the limited adjustments made in 1959 in the definition of life insurance reserves were carefully considered and did not purport to change the accepted method of computing life insurance reserves pursuant to state law.

Since it was settled long before 1959 that life insurance reserves for tax purposes as well as for state regulatory purposes include reserves computed on the assumption that all premiums have been paid and since Congress indicated that only carefully specified changes were to be made in the definition of life insurance reserves under the 1959 provisions, any reduction in life insurance reserves should be rejected as contrary to congressional language and intent. One is tempted to recall Mr. Justice Holmes' statement in an early tax case that "[u]pon this point a page of history is worth a volume of logic."[61] But the temptation subsides when

use of mortality or morbidity tables instead of experience tables as in the House bill eliminates any possibility of excluding reserves which are based on sound tables which are not compiled from actual experience. The elimination of contingent claims from the House bill is to permit the liability arising from insurance contracts providing for the payment of the proceeds in installments certain for a specified period and a continuation of their installment payments to a beneficiary so long as he might live, to be classified as a reserve if the contract involved a life contingency even if some part of the liability was held to meet noncontingent claims. It is also made clear that life insurance reserves include reserves for annuity contracts, including life insurance or annuity contracts combined with noncancelable health and accident insurance contracts. The provisions of existing law with respect to reserves of assessment life insurance companies or associations which were omitted in the House bill are inserted." S. Rep. No. 1631, 77th Cong., 2d Sess. 145 (1942).

[61]*New York Trust Co. v. Eisner*, 256 U.S. 345, 349 (1921).

one realizes that, in addition to the page of forty years of history, neither the provisions enacted in 1959 nor logic will support the tampering with life insurance reserves suggested by Petitioner.

3. The regulation purporting to require that life insurance reserves must be reduced if deferred and uncollected premiums are excluded from premium income and assets is either inapplicable or invalid.

Although there is no specific or implicit support in relevant statutory language or legislative history for such position, Petitioner in his regulations threatens the following treatment of life insurance reserves if his position is not accepted on the inclusion of deferred and uncollected premiums in income and assets:

> "In the event it is determined on the basis of the facts of a particular case that premiums deferred and uncollected and premiums due and unpaid are not properly accruable for the taxable year under section 809 and, accordingly, are not properly includible under assets (as defined in section 805(b)(4)) for the taxable year, appropriate reduction shall be made in the life insurance reserves. This reduction shall be made when the insurance company has calculated life insurance reserves on the assumption that the premiums on all policies are paid annually or that all premiums due on or prior to the date of the annual statement have been paid." (Treasury Regulations, Section 1.801-4(f).)

This regulation may not be relevant to the alternative position presented by Petitioner in this case, since the regulation appears to be directed to unusual particular

factual situations where a determination with respect to deferred and uncollected premiums is made "on the basis of the facts of a particular case . . . ." Since Petitioner's alternative position involves, not a particular factual determination that a trial court might make, but rather a proposed rule of general applicability to the life insurance industry as a whole, the regulation could be interpreted to be inapplicable with respect to the questions presented in this case. Moreover, the regulation might be interpreted as lending no support to Petitioner's alternative position because only "appropriate" reductions are called for and the statutory provisions and legislative history indicate that the suggested reduction in reserves would not be "appropriate."

However, if the quoted regulation were interpreted to require a general reduction in life insurance reserves, the regulation would exceed statutory authorization. No statutory authority for such reduction in life insurance reserves is cited by Petitioner. Rather, without the aid of statutory language or legislative history, Petitioner asserts the existence of an alleged proportional relationship between a life insurance company's reserves and assets for a particular year. As has been shown above (see pages 30-35) no requirement of simple proportionality of reserves to assets is inherent in the applicable tax provisions and several statutory provisions evidence Congressional intent that assumptions or methods used in computing reserves need not be cor-

respondingly or proportionally applied in the computation of income and assets. Moreover, Congress clearly intended no such reduction in life insurance reserves when the 1959 provisions were enacted. Thus, if the quoted regulation would require a general reduction in the life insurance reserves of Respondent and other life insurance companies, the regulation would be invalid because unauthorized. *See United States v. Cartwright*, 411 U.S. 546 (1973).

CONCLUSION

Deferred and uncollected premiums may not properly be included in premium income or in assets of a life insurance company since a life insurance company has not received such premiums by the end of a particular tax year and has no right to receive such premiums. However, if some portion of deferred and uncollected premiums were included in premium income and assets, loading on such premiums or at least the expenses of collecting such premiums should in any event be excluded. Finally, the Petitioner's alternative position that life insurance reserves should be reduced if deferred and uncollected premiums are not included in premium income and assets should be rejected because such proposed treatment is not authorized by the applicable statutory provisions and is inconsistent with the indicated intent of Congress.

Respondent therefore asks that this Court affirm the decision of the Court of Appeals for the Tenth Circuit in this case.

Respectfully submitted,

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